Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Grove	Analyst:	Jessica Deitchman	Bill Number:	AB 328
Related Bills:	See Legislative History	Telephone:	845-6310	Introduced Date:	February 13, 2015
		Attorney:	Bruce Langston	Sponsor	

SUBJECT:	Minimum Franchise or Annual Tax/Exempt New Veteran-Owned Small Businesses

SUMMARY

This bill would, under the Personal Income Tax Law and Corporation Tax Law, eliminate the minimum franchise tax or annual tax for new veteran-owned small corporations and limited liability companies (LLC).

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for this bill is to provide tax relief for new veteran-owned small corporations and LLCs doing business in California, by eliminating the minimum franchise tax or annual tax.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2016.

FEDERAL/STATE LAW

Unless specifically exempted by statute, every corporation that is organized or qualified to do business or doing business in this state (whether organized in state or out-of-state) is subject to the minimum franchise tax. Taxpayers must pay the minimum franchise tax only if it is more than their measured franchise tax. For taxable years beginning on or after January 1, 1997, only taxpayers whose net income is less than approximately $9,040 pay the minimum franchise tax because their measured tax would be less than $800 ($9,039 x 8.84% = $799).

Every corporation that incorporates or qualifies to do business in this state on or after January 1, 2000, is exempt from the minimum franchise tax for its first taxable year. This exemption does not apply to any corporation that reorganizes solely for the purpose of avoiding payment of its minimum franchise tax. It also does not apply to limited partnerships; limited liability companies not classified as corporations, limited liability partnerships, charitable organizations, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, financial asset securitization investment trusts, and qualified Subchapter S subsidiaries.

Board Position:						Executive Officer	Date
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Under existing state law, the annual tax on limited partnerships, limited liability companies not classified as corporations, and limited liability partnerships is set at $800 by reference to the minimum franchise tax.

A corporation wholly owned by an individual that is a member of the U.S. Armed Forces is exempt from paying the minimum franchise tax for any taxable year if both of the following apply:

- The owner is deployed during that taxable year, and
- The corporation operates at a loss or ceases operation in that taxable year.

THIS BILL

For taxable years beginning on or after January 1, 2016, this bill would do the following:

- Exempt an LLC that is a new veteran-owned small business from paying the annual tax for its first three taxable years, and
- Exempt a corporation that is a new veteran-owned small business from paying the minimum franchise tax for its second and third taxable years.

This bill would define the following terms:

- “New veteran-owned small business” means either:
  - a veteran-owned LLC that is formed under the laws of this state or has qualified to transact intrastate business in this state that begins operations at or after the time of its formation, and that has total income derived from, or attributable to, the state of two hundred fifty thousand dollars ($250,000) or less.
  - A veteran-owned corporation that is incorporated under the laws of this state or has qualified to transact intrastate business in this state that begins business operations at or after the time of its incorporation and that has a total income derived from, or attributable to, the state of two hundred fifty thousand dollars ($250,000) or less.
  - “New veteran-owned small business” does not include either of the following:
    - An LLC that began business operations as a sole proprietorship, a partnership, a corporation, or any other form of business entity prior to its formation.
    - Any corporation that began business operations as a sole proprietorship, a partnership, or any other form of business entity prior to its incorporation.
- “Veteran” means an individual honorably discharged from the Armed Forces of the United States.
- “Veteran-owned limited liability company” means an LLC in which more than 50 percent of the membership interest is owned by one or more veterans.
- “Veteran-owned corporation” means a corporation in which stock representing more than 50 percent of the voting power of the corporation and the value of the stock of the corporation, is owned by one or more veterans.

The exemption would be unavailable to any corporation or LLC that reorganizes solely for the purpose of reducing its annual tax or minimum tax.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The phrase "total income derived from or attributable to the state" is undefined in this bill. The absence of a definition to clarify this phrase could lead to disputes with taxpayers and would complicate the administration of this exemption. The author may wish to use the definition found in the LLC fee statute.[1]

Because the bill fails to specify otherwise, "new" veteran-owned small businesses that organized prior to January 1, 2016 could be eligible for the exemption this bill would provide. If the author intends to limit the exemption to qualifying small businesses organized on or after January 1, 2016, this bill should be amended.

A corporation or LLC could have income in excess of $250,000 and still qualify for the exemption, as long as it is not "income from or attributable to the state." If this is contrary to the author's intent, the bill should be amended.

LEGISLATIVE HISTORY

AB 1769 (Dababneh, 2013/2014) would have exempted certain small business LLCs from the minimum franchise tax for up to two taxable years. AB 1769 failed passage out of the Assembly by the constitutional deadline.

AB 1889 (Hagman, 2013/2014) would have exempted certain small business entities from the minimum franchise tax for up to the first two taxable years. AB 1889 failed passage out of the Assembly by the constitutional deadline.

AB 2428 (Patterson, 2013/2014) would have eliminated the minimum franchise tax for new business entities for up to five taxable years. AB 2428 failed passage out of the Assembly by the constitutional deadline.

AB 2466 (Nestande, et al., 2013/2014) would have reduced or eliminated the annual fee or minimum franchise tax for certain veteran-owned small business LLCs and corporations. AB 2466 failed passage out of the Assembly by the constitutional deadline.

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[1] Revenue and Taxation Code Section 17942(b)(1).

AB 2495 (Melendez, 2013/2014) would have eliminated the minimum franchise tax for new business entities for up to five taxable years. AB 2495 failed passage out of the Assembly by the constitutional deadline.

SB 641 (Anderson, 2013/2014) would have eliminated the minimum franchise tax for certain new corporations for the first four taxable years. SB 641 failed passage out of the Senate by the constitutional deadline.

AB 166 (Cook, 2011/2012) would have eliminated the minimum franchise tax. AB 166 failed passage out of the Assembly by the constitutional deadline.

AB 368 (Morrell, 2011/2012) would have reduced the minimum franchise tax to $400 for qualified small businesses. AB 368 failed passage out of the Assembly by the constitutional deadline.

AB 821 (Garrick, 2011/2012) would have reduced the minimum franchise tax from $800 to $100 for a small business for the first ten years of operation. AB 821 failed passage out of the Assembly by the constitutional deadline.

AB1605 (Garrick, 2011/2012) would have exempted specified entities from the minimum franchise tax or annual tax and reduced the minimum franchise tax or annual tax to $99 for specified entities that commence business on or after January 1, 2013. AB 1605 failed passage out of the Assembly by the constitutional deadline.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Michigan, and Minnesota do not impose a minimum tax on business entities.

Illinois, *Massachusetts*, and *New York* do impose a minimum tax on corporations, but they lack an exemption similar to the one proposed in this bill.

FISCAL IMPACT

Department costs have yet to be determined. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 328 As Introduced February 13, 2015 Assumed Enactment After June 30, 2015 ($ in Millions)		
2015-16	2016-17	2017-18
- $17.0	- $22.0	- $23.0

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The estimated revenue impact of this bill would depend on the number of new veteran-owned corporations and LLCs that are within the first three taxable years and have net California income of $250,000 or less, and are currently required to pay the minimum franchise tax or annual LLC tax.

In order to estimate the general fund impact, the following information was gathered, the number of new corporations and LLCs for 2014, the percentage of corporations and LLCs that will meet the income restrictions, and the percentage of those corporations and LLCs that are owned by veterans. Using Secretary of State data, it is estimated that 107,000 and 95,000 of corporations and LLCs would form respectively. Using the 2012 corporate sample, it was calculated that 73 and 83 percent of new corporations and LLCs, respectively, would have total income attributable to or derived from California of $250,000 or less. U.S. Census data shows that 9 percent of businesses are majority-owned by veterans. Based on FTB tax data it was assumed that 90 percent of these corporations and 100 percent of the LLC startups paid minimum tax or annual tax in 2014. Using Bureau of Labor Statistics (BLS) data it was further assumed that 85 percent of the startup businesses would survive in subsequent years. Adjustments were also made to account for companies that would exceed the $250,000 income threshold or that would pay some amount of measured tax. In year two it is estimated that 93 percent of the entities will qualify. In year three, it is estimated that 88 percent of entities would still qualify.

For the 2016 taxable year it was estimated 12,900 corporations (6,500 formed in 2014 and 6,700 formed in 2015) and 22,400 LLCs (7,500 in 2014, 7,200 in 2015, and, 7,700 in 2016) would benefit from this bill. Newly formed corporations are not subject to minimum franchise tax in their first year, hence there would be no revenue attributable to tax year 2016 for corporations in the first year of operation. This amount must then be reduced to account for business turnover and companies that no longer qualify for this bill resulting in a $7 million loss for corporations ($4 million the second year and $3 million the third year of operation) and a $13 million loss for LLCs in 2016 ($3 million third year, $4 million second year and $6 million first year of operation) for a total loss of $20 million in 2016.

The 2016 tax year estimate was then grown, converted to fiscal years and then rounded to arrive at the estimates s reflected in the table above.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that the bill would give a needed tax break to new veteran-owned small corporations and LLCs in California and therefore assist them to stay in business.

Opponents: Some may argue that providing a tax break to new veteran-owned small corporations and LLCs may be overly narrow and inadvertently exclude other business owners that need assistance.

POLICY CONCERNS

This bill would provide a tax benefit for LLCs and Corporations that would not be provided to other business entities. Thus, this bill would provide differing treatment based solely on business organization.

LEGISLATIVE STAFF CONTACT

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